Written evidence from the Royal Bank of Scotland Group

Summary

- We recognise that consumers' trust in banks has suffered greatly since the onset of the financial crisis. To a considerable extent, this loss of trust is linked to the weaknesses exposed in banks' fundamental safety and soundness, and there has been considerable progress since the crisis in restoring banks' financial strength.

- It may prove more difficult to restore public trust that banks will put their customers first. We believe the Parliamentary Commission has an important role to play not just in raising standards across the industry but also in giving recognition to those areas where progress has in fact been made.

- In 2009 RBS faced immediate issues of safety and soundness, and like other banks has prioritised action on this front.

- This has resulted in one of the largest corporate restructurings ever undertaken, with a substantial reduction in the size of our balance sheet while at the same time increasing lending in our core UK retail and commercial businesses while protecting customers who are also our future. We have increased our Core Tier 1 capital ratio from 4% to over 10% and thoroughly restructured our funding position, with greatly reduced dependency on wholesale funding markets.

- We have also taken a range of measures aimed at making the Group more customer-focused and to improve management. While we consider these measures to be important, we have no illusions about their ability to effect instant cultural change.

- We believe that the delivery of real cultural change is more likely to be a consequence of having created a good company that serves its customers well than of having implemented a standalone programme of cultural change.

- We welcome the developing role of the Chartered Banker: Professional Standards Board. We would support giving the CB:PSB powers to maintain a register of accredited bankers and to strike off those who fall short of the required standards, subject to appropriate safeguards around due process.

1. *To what extent are professional standards in UK banking absent or defective? How does this compare to (a) other leading markets (b) other professions and (c) the historic experience of the UK and its place in global markets?*

1.1. The level of professional standards in UK banking must, in the most general sense, be judged by our customers. As discussed below, the succession of scandals that has hit banking in recent years has ensured that their immediate judgment would not be positive.

1.2. We recognise that our customers are looking to us to improve our standards of professionalism and expertise so that we can deliver the levels of service they expect. This has not been easy. In many cases the training and professional qualifications we believe are necessary did not exist. We have had to develop a number of bespoke programmes to meet our requirements, as well as participating in industry-wide initiatives to raise standards.

1.3. RBS is a founding member of the Chartered Banker: Professional Standards Board (CB:PSB). It was established by the Chartered Banking Institute in October 2011 to enhance and sustain a

strong culture of ethical and professional development across the UK banking industry. The CB:PSB will:

- Outline the need, scope and application of professional standards.
- Monitor and enforce professional standards.
- Introduce an industry-wide ethical code of conduct.

1.4. Following consultation with all member banks, in July 2012 the CB:PSB published the Chartered Banker Code of Professional Conduct and a Foundation Standard setting out the values, attitudes and behaviours it expects of all UK banking professionals. RBS will ensure that the standards are implemented and/or integrated into existing standards and development programmes.

1.5. It is important to recognise, however, that requirements vary across the spectrum of banking, and the existing Code of Professional Conduct is more geared towards retail than wholesale banking. We are working towards a consistent goal of attaining professional standards across the Group. There is no one-size-fits-all provider of professional development and qualifications that currently meets our varied business needs. In the UK alone, we partner with over 40 different professional institutes for the provision of qualifications and development.

1.6. We also consider that formal professional standards are only one facet of the question. More important, in the longer run, is the range of basic management disciplines that ensure that a company puts its customers' interests first and at the heart of everything it does.

1.7. We take very seriously the task of developing current and future managers across the organisation who will demonstrate this commitment to customers' interests and have the competences, values and behaviours to ensure that our staff live up to this. This involves a strong commitment to recruiting and training a diverse workforce (we recruited 12,000 new employees in the UK last year, including 500 graduate recruits) and continuing emphasis on actively managing performance.

2. *What have been the consequences of the above for (a) consumers, both retail and wholesale, and (b) the economy as a whole?*

2.1. We recognise that consumers' trust in banks has suffered greatly since the financial crisis. To a considerable extent, this loss of trust is linked to the weaknesses exposed in banks' fundamental safety and soundness, and there has been considerable progress since the crisis in restoring banks' financial strength. However, it may prove more difficult to restore public trust that banks will put their customers first.

2.2. While the most measurable consequences for the economy as a whole have stemmed from the direct impact of the 2007-08 financial crisis and the subsequent enduring difficulties in the eurozone, we consider that the current level of negative feeling towards banks and bankers is unhealthy and makes it more difficult to achieve acceptance of some of the difficult trade-offs inherent in balancing conflicting demands.

2.3. Banks are, in general, highly geared to the economies within which they operate. It is rare to find strong banks in weak economies. But it is also rare to find strong economies unless their banks are also strong.

3. *What have been the consequences of any problems identified in question 1 for public trust and in, and expectations of, the banking sector?*

3.1. We recognise that consumers' trust in banks has suffered greatly since the financial crisis. To a considerable extent, this loss of trust is linked to the weaknesses exposed in banks' fundamental safety and soundness, and there has been considerable progress since the crisis in restoring banks' financial strength. However, even once banks' safety and soundness has been strengthened to a point where there it is no longer the focus of public distrust, it may prove more difficult to restore public trust that banks will put their customers first.

3.2. One consequence of this loss of trust is that there is little expectation among the public, or among regulators, that banks will prove capable of improving their cultures in a way that places the customer's interests above those of the bank. As a result, there will be little willingness to wait for results, even though delivering a better banking culture is more likely to be the product of a slow and sustained series of basic management improvements than of a single remedy.

3.3. Another consequence has been an expectation that many of the perceived problems in banking might be addressed if banks were to return to an idealised golden age in which every manager knew his customers personally and was empowered to make independent credit decisions on the basis of this personal knowledge without central office intervention.

3.4. In the mid-1950s, a time at which the independent branch manager is perceived to have flourished, "there were only about 8 million bank accounts in the UK, equivalent to barely one third of the working, let alone the total adult, population."[1] All branches closed at 3pm, bank charges were levied entirely at the manager's discretion, and credit was confined to overdrafts and short term credit (rarely beyond six months in tenor). While we have noted the widespread calls for a return to the practices of this era, we do not believe such a return would be in the interests of the vast majority of our customers.

4. *What caused any problems in banking standards identified in question 1? The Commission requests that respondents consider (a) the following general themes:*

- *the culture of banking, including the incentivisation of risk-taking;*
- *the impact of globalisation on standards and culture;*
- *global regulatory arbitrage;*
- *the impact of financial innovation on standards and culture;*
- *the impact of technological developments on standards and culture;*
- *corporate structure, including the relationship between retail and investment banking;*
- *the level and effectiveness of competition in both retail and wholesale markets, domestically and internationally, and its effects;*
- *taxation, including the differences in treatment of debt and equity; and*
- *other themes not included above;*
- *and (b) weaknesses in the following somewhat more specific areas:*
- *the role of shareholders, and particularly institutional shareholders;*
- *creditor discipline and incentives;*
- *corporate governance, including:*
    - *the role of non-executive directors*

[1] "Other People's Money – the Revolution in High Street Banking", David Lascelles, 2005.

- *the compliance function*
- *internal audit and controls*
- *remuneration incentives at all levels;*

o *recruitment and retention;*

o *arrangements for whistle-blowing;*

o *external audit and accounting standards;*

o *the regulatory and supervisory approach, culture and accountability;*

o *the corporate legal framework and general criminal law; and*

o *other areas not included above.*

4.1. We consider that most of the problems in banking standards can be related to a single basic issue: the failure to serve customers properly. While the vast majority of bank staff are squarely focused on doing a good job for their customers, it is clear that banks as a whole have not kept pace with some other industries in delivering the services and products their customers want.

4.2. In the decade preceding the financial crisis, the banking industry expanded too fast, with too much focus on income and profit, and too little on capital, risk and liquidity. This led to a regrettable tendency to promote products that delivered short-term income, rather than those that generated more sustainable benefits over time. Payment protection insurance is an example of this: PPI sales created income that could be booked at inception, rather than the slower income stream derived from the underlying loan. Sales were prioritised over service, and banks failed to balance their interests of their customers, their shareholders and their managers.

4.3. The persistence of a flat yield curve contributed to an inadequate appreciation of the real costs of term liquidity. As a result, banks were willing to take on longer term exposures than could be reconciled by the maturity profile of their funding.

4.4. Banks’ emphasis on growing income and profit had its counterpart in investors’ focus on growth. In some instances investors’ pressed for what were arguably unsustainable levels of return, creating pressure to increase leverage and take on additional risk.

4.5. Remuneration structures clearly played a role in encouraging some of these patterns of behaviour. Most banks have recognised this by instituting changes to the way they pay their staff, so that customer satisfaction and risk control, rather than just profit or income, determine pay levels.

4.6. We do not consider that the universal banking structure per se was detrimental to banking standards; as discussed in 4.2 above, misdirected sales occurred extensively in retail banking, as well as in wholesale banking. Nor was the universal banking model in itself more prone to instability. Over the period January 2007-February 2009 universal banks’ losses averaged 1.2% of average total assets, compared to 2.2% for narrow investment banks and 3.0% for narrow retail and commercial banks.

4.7. Ultimately, restoring basic management disciplines and embedding customer focus are the key to remedying the shortcomings that became apparent.

5. *What can and should be done to address any weaknesses identified? To what extent are such weaknesses subject to remedial corporate, regulatory or legislative action, domestically or internationally?*

5.1. The immediate priority of regulatory and legislative action in the wake of the financial crisis of 2007-08 was to address the issues financial stability exposed during the crisis, including weaknesses in capital, liquidity, risk management and resolvability. Similarly, individual banks needed to focus their immediate efforts on restoring their safety and soundness.

5.2. It may, to some extent, be viewed as a measure of the progress achieved in that regard that public attention is now focused more on questions of standards and culture, rather than simply of survival.

5.3. At RBS, that recovery process has involved one of the largest corporate restructurings ever undertaken. We have reduced the size of our balance sheet by £700 billion, while at the same time increasing lending in our core UK retail and commercial businesses, protecting customers who are also our future. We have increased our Core Tier 1 capital ratio from 4% to over 10% and thoroughly restructured our funding position, with greatly reduced dependency on wholesale funding markets.

5.4. The process of producing enduring improvements in standards and culture is more likely to be the product of a slow, deliberate and sustained march with many small steps, rather than one-off legislative or regulatory changes. Much of this essentially relates to basic management disciplines.

5.5. RBS has made it a priority to improve its customer focus, and has made a start on this. We have revised the Group’s statement of purpose, vision and values to give primacy to our customers’ interests. RBS’s Board is currently reviewing our code of conduct to make sure it reflects the values we aspire to and, as importantly, that it brings these values to life for our employees.

5.6. In response to feedback from SMEs for greater expertise levels, in June 2011, RBS launched an internal accreditation programme for relationship managers in Business and Commercial Banking. Every manager is required to complete modules in relationship management, risk, customer solutions and customer insight. RBS sees this programme as essential to developing our knowledge and skills so we can continue to help our customers realise their business ambitions. The programme is now externally accredited by the Chartered Banker Institute. To date, 3,700 corporate banking managers have been accredited.

5.7. The UK Retail division is working towards meeting the new regulatory requirements governing the professional standards of retail investment advisors by the end of this year. The objectives of the FSA Retail Distribution Review (RDR) are to establish minimum qualifications, raise standards of behaviour and secure the trust and confidence of the public.

5.8. Also in UK Retail, RBS has launched a Helpful Banker accreditation programme in collaboration with the Chartered Banker Institute. The programme includes induction, e-learning, assessment and requires the achievement of minimum standards. Colleagues who successfully complete the programme receive an externally recognised qualification – the Professional Banker Certificate, awarded by the Chartered Banker Institute. Since its launch earlier this year, over 300 colleagues have been accredited. Our aim is that 3,000 Retail bankers will complete the accreditation by the end of the year and a further 9,000 in 2013.

5.9. Remuneration in banks is an important and sensitive topic. Pay and incentive structures have a key role to play in supporting cultural change and appropriate risk behaviour. We have taken steps to overhaul these structures across RBS. It is, perhaps, fair to say that our focus initially was on reforming pay so as to achieve a better balance between employee and shareholder interest by, for example, paying bonuses in shares, not cash, and making awards subject to deferral and clawback so that performance could be evaluated over a longer term. Now our reform agenda has to go

further so that pay also takes proper account of the customer interest. That means that pay awards must take account of customer satisfaction as well as risk-adjusted financial performance.

5.10. The new and enhanced process for individual accountability review assessments (which consider material risk management, control and general policy breach failures, accountability for those events and appropriate action against individuals) is operated across divisions and functions. The new accountability review assessments approach was sponsored and approved by Group Board Risk and Remuneration Committees.

5.11. The annual incentive pool is based on a balanced scorecard of measures including financial performance, risk, people and customer measures to better align shareholder and customer interests. Capital adequacy is also taken into account.

5.12. Within our UK Retail division we have replaced a pay structure based on sales incentives with one that rewards customer service and satisfaction. The scheme was introduced in January 2012 for branch and relationship employees linked to our Helpful Banking strategy. The scheme was introduced for employees providing telephone-based service in April 2012.

5.13. The new incentive schemes operating in the Retail division focus on retaining, growing and acquiring customer relationships based on great service and sales that are fully aligned to the customer’s needs and our strategy of becoming the UK's most helpful bank. Payouts are determined on a mix of measures appropriate to each role with the most significant being Customer Service, Branch Contribution and Deposit Balance Growth. All participants must pass risk assessments and customer satisfaction hurdles and, in addition, all people managers need a minimum score in relation to feedback from their employees before they can participate.

5.14. We have recently completed an initial review of the scheme where we looked at financial analysis, customer and business outcomes as well as staff feedback. We are making some small changes to the scheme as a result.

5.15. Establishing good corporate governance is a key element of management and cultural change in the Group. In May 2011, the Board introduced a new Corporate Governance Policy to demonstrate that we are committed to the highest standards of governance, integrity and professionalism throughout the Group. The policy comprises ten principles and related guidance that apply across the Group and to all divisions and jurisdictions. The principles cover areas such as decision-making, individual and collective responsibility, identifying and managing risks, risk and reward and escalation and transparency. We want to ensure we have the right structures and systems in place so that sound business decisions are made and it is important to us that we demonstrate high standards of governance in all of our activities.

5.16. Since the crisis we have fully reviewed the Board size, role, composition and the experience and qualification of its members. As a result, the membership of the RBS Board has undergone sweeping change and a Senior Independent Director has been appointed to provide support to the Chairman and perform the function of intermediary for the non-executive directors where necessary. It is essential that directors have a sound understanding of the Group’s business so that the Board is able to provide input to help shape future strategy. This is achieved through site visits, in-depth board presentations and, for new directors, their induction programme. It is important to encourage a culture in the boardroom that facilitates debate and where non executive directors are able to provide constructive challenge to the executive team. RBS conducts an annual evaluation of the effectiveness of the Board and of the individual performance of each of the non-executive directors.

5.17. We also provide mechanisms for individual employees to challenge decisions and behaviours that they consider to be unethical or wrong. RBS has a comprehensive whistle-blowing policy. It is designed to ensure employees are able and feel comfortable to raise a whistle-blowing disclosure. Following an independent review conducted by KPMG in 2009, contacts have since January 2011 been managed externally by Global Compliance Services.

5.18. While we consider these measures to be important, we have no illusions about their ability to effect instant cultural change. We fully anticipate that it will take years to follow through on this programme and that the effects may not be immediately visible. Moreover, we believe that the delivery of real cultural change is more likely to be a consequence of having created a good company that serves its customers well than of having implemented a programme of cultural change.

5.19. It is also our belief that our success in placing customers at the heart of our business must be underpinned by investment in technology. We recognise that we have in the past underinvested in our systems, and that this has contributed to making it harder for our customers to do business with us, and harder for our staff to provide the kind of service they aim for. We are committed to remedying this, but it will take time to make up the past shortfall. Nor can this be a one-off investment; continuing efforts will be needed to maintain our technological capabilities.

6. *Are the changes already proposed by (a) the Government, (b) regulators and (c) the industry sufficient? Respondents may wish to refer to the Financial Services Bill and the Government's proposals for the Banking Reform Bill. They may also wish to refer to proposals by the Bank of England and the Financial Services Authority on how the Financial Policy Committee, Prudential Regulation Authority and Financial Conduct Authority will operate in practice.*

6.1. The extensive programme of prudential, macro-prudential, structural and regulatory changes that is under way has already done much to create a safer and more stable banking system, and we see further benefits as this programme is completed. This improvement in safety and soundness should of itself help rebuild customer confidence in banks.

6.2. In relation to professional standards in banking, we welcome the CB:PSB’s efforts to seek new, independent board members. We support efforts to develop a memorandum of understanding between the CB:PSB and the Financial Conduct Authority cementing its position as the instrument for setting and monitoring professional standards in banking.

6.3. We would also support giving the CB:PSB powers to maintain a register of accredited bankers and to strike off those who fall short of the required standards. We recognise that there is strong support from the public for bankers to be accredited, and RBS is already making progress towards the accreditation of customer-facing roles in the UK. Provided the standards expected are reasonable, the consequences of breaching those standards clear, and the processes of investigation, judgment and appeal fair, we do not believe that organisations or individuals should fear this approach.

7. *What other matters should the Commission take into account?*

7.1. We are seeking to rebuild an RBS that is stronger and safer than it was in the past. We recognise that the critical role our banking and payments services play in everyday life means that we must take full account of the wider social impact of our actions.

7.2. We recognise our obligation to be a positive force in the communities in which we operate, and have embraced this responsibility. This includes our pledge to maintain banking services wherever we are the last bank in town, as well as the financial education we provide to secondary students through our MoneySense programme. Acting as a responsible citizen also means working within both the letter and the spirit of the law and abiding by relevant codes of practice.

7.3. We consider that the work we are doing to ensure the sustainability of our business is an integral part of our overall recovery plan, contributing to the long-term performance of the company and its return to enduring profitability.